

New Zealand Fixed Income Monthly

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Pricing in the front end of the yield curve

Since the Reserve Bank of New Zealand (RBNZ) postponed a widely expected rate hike in August, pricing in the market has pulled back, supporting a view that the central bank will hike rates by 25 basis points (bps) at each of its next three policy meetings. Some economists are even projecting that the RBNZ will eventually take the Official Cash Rate (OCR) from the current 0.25% to near 2%, a level the central bank views as the neutral interest rate. However, we must remember that the RBNZ reduced the OCR by 75 bps in 2020 as an emergency response to the pandemic; our view is that the central bank, after reversing its emergency measures by taking the rate back to 1% with three 25-bps hikes, could enter a period of reflection.

The reason we expect a possible pause by the RBNZ is that many of the key drivers of growth, highlighted below, face possible headwinds.

- Net migration into New Zealand in 2020 provided a consumption-driven boost to the economy as expats returned home to the country's relative safety during the peak of the global COVID-19 outbreak. Migration, however, has dropped recently; we may even see a net outflow of people once travel restrictions are relaxed as skilled New Zealanders might seek higher wages and greater promotion opportunities in larger economies.
- Building activity, another driver of growth that increased during the pandemic, could also taper off as some of the demand had streamed from the massive synchronised global stimulus, which may be at, or already past, its peak.
- Wage subsidy, through which NZD 15 billion—about 4.5% of the country's nominal GDP—was dispersed, represents a massive sugar hit that the economy will have to learn to live without.
- International tourism to New Zealand may eventually return, but in a slow and measured pace. The country will be competing for tourist dollars with a number of other global locations; furthermore, New Zealand's remoteness and risk that its borders could be closed with little notice could prompt tourists to choose other destinations.

We believe that the above factors could make the RBNZ pause as they take a path towards a more neutral policy. What then, does this mean for the front end of the interest rate curve? First, a significant part of the move higher in rates has already been priced into the front end, so investors could be comfortable with their existing positions in this section of the curve. Second, markets often overshoot and therefore it is possible that rates will move up slower relative to prices, again providing comfort to those holding front-end positions.

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